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ABSTRACT

Thirty options for reducing guaranteed student loan defaults and related federal costs are provided by the General Accounting Office (GAO). The options are presented by groups of program participants: students, schools, lenders, guaranty agencies, and the Department of Education. These options include: adopt GAO's past recommendation to increase the loan interest rate of borrowers who default; adopt GAO's past recommendation to require guaranty agencies to use the National Student Loan Data System to verify borrower eligibility; standardize policies for refunding tuition and fees to students who fail to complete enrollment periods; delay loan disbursements to students and schools for some period after classes begin; require that lenders share the default risk; strengthen enforcement of lender due diligence standards and assess penalties for noncompliance; increase guaranty agencies' default risk or restructure the way in which they share this risk; enforce the provision requiring that all guaranty agencies add reasonable collection costs to defaulters' debts; give the Department of Education stronger program sanctions against lenders and guaranty agencies; and adopt recommendations for continuing the Internal Revenue Service income tax refund offset program for defaulted student loans. (SW)

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GAO

United States General Accounting Office

Briefing Report to Congressional Requesters

January 1990

GUARANTEED STUDENT LOANS

Potential Default and Cost Reduction Options

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United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

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January 7, 1988

The Honorable Pat Williams
Chairman, Subcommittee on
Postsecondary Education
Committee on Education and Labor
House of Representatives

The Honorable William D. Ford
House of Representatives

This report presents a variety of options for reducing guaranteed student loan defaults, and related federal costs, which we discussed with Mr. Ford and Committee staff on December 8, 1987. At that time, we described recent legislative and regulatory changes to the program that could be expected to influence loan default costs as well as additional default-related measures that the Congress and the administration could take. The briefing's overall theme was that a series of incentives and penalties are needed to encourage the various program participants to better manage the default problem and the program in general. Mr. Ford later requested that we provide him and the Subcommittee with a written description of the options that we believe have a good probability of reducing defaults or defraying associated program costs.

We understand that the Subcommittee plans to seek the views of representatives of the various program participants, including students, schools, lenders, guaranty agencies, and the Department of Education, on the desirability of these and other alternatives during January 1988, and to later hold hearings to identify ideas that merit legislation.

Many of the alternatives presented in this report are based on our previous work, and where we made recommendations in earlier GAO reports, we have cited those reports. We continue to believe that these recommendations should be implemented. Other options are based on our general program knowledge or on the suggestions of the guaranty agencies, the Department of Education, and others. We have not fully analyzed the feasibility of each option presented, although we believe each has enough merit to warrant further discussion in the political process which, by its nature, involves the input of all the affected parties. We have also not attempted to present an exhaustive list of the possibilities for reducing student loan defaults. We believe, however, that those presented address the major problem areas for each of the five participant groups and should give the Subcommittee a good framework for further discussion.

In preparing this report, we reviewed recent program changes and legislative and regulatory proposals that had been developed by representatives of the various program participants.

BACKGROUND AND RECENT CHANGES

As more and more students with guaranteed student loans leave school, loan defaults have risen dramatically--from $300 million in fiscal year 1982 to $1.3 billion in fiscal year 1987--and they can be expected to continue increasing. The increases in federal costs led to a number of recent legislative and regulatory changes intended to reduce default costs. These changes have generally strengthened loan origination and collection requirements for lenders and guaranty agencies and should result in additional actions to avoid defaults and improve collection effectiveness.

Certain of these changes also provide for increased oversight and audit of guaranty agency and lender performance in managing defaulted loans. For example, these new requirements subject (1) guaranty agencies to biennial financial and program audits and (2) larger lenders and schools to periodic guaranty agency oversight. The changes also require that loan proceeds be disbursed to students more frequently, rather than once per year, and that checks be sent to the school for subsequent endorsement by the borrower. When students default, their debts must now be reported to credit bureaus and can be offset against their federal income tax refunds. Defaulters are also expected to pay reasonable collection costs related to their debts.

Taken together, these changes could significantly reduce default costs, although it may be some time before such reductions will become observable.

OPTIONS TO REDUCE DEFAULTS AND RELATED FEDERAL COSTS

We have organized the options in this report by the five major groups of program participants, listing each option with the group most directly affected.

Students

An option that would affect students would require borrowers under the Supplemental Loans for Students (SLS)[1] program to pay

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[1]SLS loans are unsubsidized loans bearing market rates of interest available to students. "Regular" guaranteed student loans carry an interest rate (8 percent) that is generally several percentage points below the unsubsidized interest rate on SLS loans. SLS loan volume has been growing rapidly in recent years.

a loan origination fee similar to that charged for "regular" guaranteed student loans. This would raise additional program revenue against which losses for these loans could be applied. We are aware of no reason why defaults under the SLS program could be expected to be significantly lower than those for other guaranteed student loans. Other options include eliminating the grace period allowed students before beginning repayment after leaving school, for students who drop out; and charging market interest rates to borrowers who default on "regular" guaranteed student loans.

Schools

Significant options affecting schools are (1) standardizing school refund policies for tuition and fees for students who drop out before completing their enrollment periods and (2) providing effective counseling to borrowers on their loan repayment responsibilities. The first option would give borrowers who drop out early larger refunds which they could use to help repay their loans, while the second should help ensure that borrowers understand their loan obligations and the possible penalties for nonpayment, thus providing a repayment incentive. Other options that could help reduce defaults include delaying loan disbursements to students attending schools with high default rates for some period after the beginning of each term and establishing penalties for schools that fail to lower their default rates.

Lenders

Lenders generally have no financial risk in this program unless they fail to follow program requirements, such as those governing their collection activities. Asking lenders to assume part of the default risk could give them a stronger incentive to control default costs while retaining the underlying federal guarantee against significant losses. Such a mechanism could function similar to risk-sharing provisions under home loan programs operated by the Veterans Administration and the Federal Housing Administration in which lenders share the risk and absorb a portion of defaulted losses. Risk sharing could be implemented in various ways. For example, lenders could be provided less than a full repayment guarantee, of perhaps 99-percent reimbursement rather than the current maximum 100-percent guarantee against losses they sustain. Another option would subject borrowers under the Parent Loans for Undergraduate Students and SLS programs to the same multiple disbursement provisions applicable to "regular" guaranteed student loans. Disbursing loans to students at the beginning of each semester or quarter rather than once per year can reduce default costs for defaulting borrowers who drop out during the year.

Guaranty agencies

Several recommendations in our recent report on collection activities by the guaranty agencies would also reduce default costs. (Guaranteed Student Loans: Legislative and Regulatory Changes Needed to Reduce Default Costs, GAO/HRD-87-76, Sept. 30, 1987.) For example, we recommended that these agencies follow the generally stricter Federal Claims Collection Standards the Department of Education imposes on itself and its collection contractors. Other options would require guaranty agencies to (1) charge students the maximum legal insurance premium of 3 percent (which could help defray default costs) and (2) assume a greater share of default risk, which is now borne principally by the federal government.

The Department of Education

Options for which the Department's implementation would be crucial include (1) encouraging stronger enforcement of existing program requirements and (2) improving departmental oversight of schools, lenders, and guaranty agencies. In addition, as noted in our September 1987 report, we believe the Department should be given longer term authority to use the federal income tax refund offset (which was recently extended through June 30, 1988).

We also have underway other work that is likely to identify more opportunities to reduce default costs, including a study of state and multistate guaranty agencies required by section 1311 of the 1986 Higher Education Amendments. The results of that work should be sufficiently developed to brief the Subcommittee before any future hearings on the default issue.

As requested by your office, we did not obtain written comments from the Department of Education on this report. However, we discussed its contents with agency officials and incorporated their suggestions where appropriate. We are sending copies of this report to the appropriate congressional committees, the Secretary of Education, and other interested parties.

For further information regarding this report or our other studies, please call me on 275-5365.

William J. Gainer

William J. Gainer
Associate Director

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Abbreviations

GAO	General Accounting Office
GED	general equivalency diploma
IRS	Internal Revenue Service
JTPA	Job Training Partnership Act
PLUS	Parent Loans for Undergraduate Students
SLS	Supplemental Loans for Students

Figure 1
Potential Default and Cost Reduction Options Affecting Students

- **Option 1:** Adopt GAO's past recommendation to increase the loan interest rate of borrowers who default.
- **Option 2:** Adopt GAO's past recommendation to require guaranty agencies to use the National Student Loan Data System to verify borrower eligibility.
- **Option 3:** Charge PLUS/SLS borrowers loan origination fees.
- **Option 4:** Eliminate the grace period for students who drop out of school before completing their academic program.
- **Option 5:** Withhold transcripts of borrowers who default on their loans.

POTENTIAL DEFAULT AND COST REDUCTION OPTIONS AFFECTING STUDENTS

OPTION 1: Adopt GAO's past recommendation to increase the loan interest rate of borrowers who default.

In our September 1987 report Guaranteed Student Loans: Legislative and Regulatory Changes Needed to Reduce Default Costs (GAO/HRD-87-76, Sept. 30, 1987), we noted that under current law, borrowers who default continue to be charged the loan interest rates on the subsidized loans they originally received. In contrast, the interest rate on loans of borrowers who do not default increases from 8 to 10 percent during the fifth year of repayment. In addition, borrowers obtaining Parent Loans for Undergraduate Students (PLUS) and Supplemental Loans for Students (SLS) pay interest at a market rate (currently 10.27 percent), with a ceiling of 12 percent. We recommended to the Congress that borrowers who default on their loans be charged a variable rate of interest up to 12 percent, or higher if permitted by state law. Such a change would reduce federal costs and could help deter borrowers from defaulting.

The Congress has not acted on this recommendation.

OPTION 2: Adopt GAO's past recommendation to require guaranty agencies to use the National Student Loan Data System to verify borrower eligibility.

In our September 1987 report, we noted that while the Secretary of Education had been given the authority to establish a National Student Loan Data System, guaranty agencies would have the option to use the system to verify borrower eligibility. We recommended that the Higher Education Act be amended to require the agencies to use the system to help prevent fraud and abuse by borrowers who are already in default on a student loan, or who try to obtain multiple loans for the same period of enrollment.

The Congress has not acted on this recommendation. The Department of Education agreed with our recommendation and has supported such a legislative requirement.

OPTION 3: Charge PLUS/SLS borrowers loan origination fees.

Borrowers obtaining PLUS/SLS loans are not charged an origination fee as are borrowers obtaining subsidized guaranteed student loans. This fee, which is currently 5 percent, is collected by the lender and remitted to the Department of Education to help offset program costs. As a result of the needs test mechanism implemented by the 1986 amendments, more borrowers--especially those with income above the needs test threshold--should be obtaining PLUS/SLS loans. For example, PLUS/SLS loan volume, which was about $520 million in fiscal year

1986, increased to $1.1 billion in fiscal year 1987. If those borrowers had been charged an origination fee in 1987, the Department could have received about $55 million in additional income. In addition, the Department has estimated that the PLUS/SLS volume will increase to $1.3 billion in fiscal year 1988, which could raise another $65 million in revenue to offset program costs.

OPTION 4: Eliminate the grace period for students who drop out of school before completing their academic program.

Current law gives students a grace period of 6 months before beginning to repay their loans. When defaulters fail to complete their course of instruction and drop out of school abruptly, they can be difficult to locate to initiate repayment.

Eliminating the grace period for dropouts so that they must immediately begin repaying their loans would require schools to notify lenders and guaranty agencies as soon as they are aware of borrowers' withdrawals. Such prompt notification should facilitate locating the students and initiating repayment, thereby reducing default costs.

OPTION 5: Withhold transcripts of borrowers who default on their loans.

Schools have the authority to withhold transcripts of former students who default on their loans--which can adversely affect consideration of defaulters' applications for employment or enrollment in other postsecondary institutions--but such action is optional. While little information is available showing how many schools use the authority, mandating its use could help deter defaults and influence defaulters to repay their loans. For example, a defaulter's transcript could be released once satisfactory repayment arrangements were made with the guaranty agency.

Figure 2
Potential Default and Cost Reduction Options Affecting Schools

- **Option 6:** Standardize policies for refunding tuition and fees to students who fail to complete enrollment periods.
- **Option 7:** Delay loan disbursements to students and schools for some period after classes begin.
- **Option 8:** Give the Department the authority to regulate the procedures schools use to admit students under the ability-to-benefit provision.
- **Option 9:** Require the Department to periodically assess schools' operations and educational performance as a condition for continued title IV eligibility.
- **Option 10:** Establish penalties for schools that fail to make satisfactory progress in reducing high default rates.
- **Option 11:** Require the use of standardized borrower counseling and rights and responsibilities forms.

POTENTIAL DEFAULT AND COST REDUCTION OPTIONS AFFECTING SCHOOLS

OPTION 6: Standardize policies for refunding tuition and fees to students who fail to complete enrollment periods.

The Department of Education's regulations require that participating schools have a fair and equitable refund policy for students who (1) do not register for the period of attendance for which the loan was made or (2) withdraw or fail to complete the period of enrollment. These policies can vary from school to school and among accrediting organizations.

As cited in our August 1984 report, Many Proprietary Schools Do Not Comply With Department of Education's Pell Grant Program Requirements (GAO/HRD-84-17, Aug. 20, 1984), some institutions retained only that portion of tuition and fees appropriate to the period of time the student was in attendance, while others kept a disproportionately large portion, or all of the fees, thereby placing a greater financial burden on dropouts. Requiring a standardized policy for prorating refunds could give borrowers a larger, more equitable refund to use to help repay their loans, while creating an incentive for schools to (1) ensure that the applicants have the ability to benefit from the training being offered and (2) provide a quality education that would retain students.

OPTION 7: Delay loan disbursements to students and schools for some period after classes begin.

Borrowers who default may fail to complete their course of studies and drop out shortly after beginning classes. If a loan has already been disbursed to such students or the school they attend, the likelihood of recovering the loan is reduced. Delaying loan disbursements--particularly to students attending schools with high default rates--until students have been in attendance for a specified period of time could reduce federal default costs. Such a requirement could give schools an incentive to ensure that their students receive a quality education and remain in attendance. It could also deter students who--upon receiving their loans--quickly drop out and use the money for noneducational purposes.

OPTION 8: Give the Department the authority to regulate the procedures schools use to admit students under the ability-to-benefit provision.

If students lack a high school diploma or a general equivalency diploma (GED), they can still qualify for a loan if the school determines they have the "ability to benefit" from the course of instruction. In our August 1984 report, we found a large proportion of schools in our sample admitted students who

failed to meet the Department's ability-to-benefit admission requirements.

The Higher Education Amendments of 1986 changed the ability-to-benefit criteria to require that students receive a GED before beginning the course of study or by the end of the first year of study, or take a standardized test measuring their aptitude to successfully complete the program. If students fail the aptitude test, they must enroll in a remedial education program or its equivalent for no more than 1 year.

The Department needs to ensure, to the extent possible, that the provision's requirements are being enforced to help prevent unqualified students who are unlikely to complete courses and likely to default on their loans from being recruited and admitted by schools. However, the Department is prohibited from regulating these requirements. The law states that the Secretary shall not promulgate regulations defining the admissions procedures or remediation programs that an institution must use in admitting students on the basis of their ability to benefit. Consideration could be given to removing this restriction and, therefore, allowing the Secretary to regulate this provision.

OPTION 9: Require the Department to periodically assess schools' operations and educational performance as a condition for continued title IV eligibility.

In determining schools' eligibility to participate in the Guaranteed Student Loan Program, the Department relies primarily on the accreditation process by requiring that institutions be (1) accredited by a national accrediting agency or association approved by the Secretary, (2) in the process of obtaining such accreditation, or (3) accepted by three other accredited institutions for transfer of students' credits.

The Department has, therefore, generally neither monitored this accrediting test nor independently assessed the performance of the accredited schools. However, the Department could supplement its current procedure of relying on the schools' accreditation to determine whether they should continue participating in federal student aid programs. For example, it could perform periodic assessments of schools' operations and educational performance--in terms of such measures as dropout, completion, and placement rates.

OPTION 10: Establish penalties for schools that fail to make satisfactory progress in reducing high default rates.

The Secretary of Education has initiated a plan to take action against schools with high default rates. Specifically, the Secretary plans to limit, suspend, or terminate institutions from program participation if their default rates exceed 20

percent. The Secretary has indicated that the Department would review the circumstances of each institution exceeding the 20-percent rate before terminating the institution from the program.

While the concept appears to have merit, the appropriateness of a 20-percent threshold or other across-the-board thresholds should be assessed. In determining such a threshold, consideration could be given to the populations the schools serve. For example, school with a large population of economically disadvantaged students and a higher dropout rate might be expected to have a higher portion of students who will default on their loans than other schools.

The default rate benchmark could be established for each school using a method patterned after the performance standard adjustments used under the Job Training Partnership Act (JTPA). Using the JTPA methodology, each local training program is given higher or lower performance standards for job placements or placement wages based on a statistical formula. This formula makes adjustments for the demographic characteristics of those served by individual programs as compared to a set of characteristics of average participants for the entire national program. The formula also takes into account the difficulty of serving the various subgroups of participants.

On the other hand, the Congress could decide that a default rate above a certain percent is unacceptable, regardless of the type of institution involved.

OPTION 11: Require the use of standardized borrower counseling and rights and responsibilities forms.

Although the Guaranteed Student Loan Program is excluded from provisions of federal truth-in-lending laws, borrowers are required to receive counseling about their responsibilities from their schools, and a statement summarizing their rights, responsibilities, and the consequences of defaulting on their loans from their lenders. At a minimum, the forms the schools and lenders use should specify the repayment terms and potential penalties for nonpayment.

Standardized counseling and statements of borrowers' rights and responsibilities forms could help ensure that borrowers are receiving proper counseling and information concerning their loan obligations. Requiring borrowers to sign and receive a copy of such documents would verify receipt and serve to emphasize to the borrowers the importance of their repayment obligation and the sanctions that could be applied to them if they default.

Figure 3
Potential Default and Cost Reduction Options Affecting Lenders

- **Option 12:** Require that lenders share the default risk.
- **Option 13:** Strengthen enforcement of lender due diligence standards and assess penalties for noncompliance.
- **Option 14:** Adopt rules that could avoid potential conflict-of-interest situations between lenders and guaranty agencies.
- **Option 15:** Require cosigners on loans.
- **Option 16:** Make changes to the "rehabilitated loans" program.
- **Option 17:** Make PLUS/SLS loans subject to the same multiple disbursement provisions as subsidized guaranteed student loans.

POTENTIAL DEFAULT AND COST REDUCTION OPTIONS AFFECTING LENDERS

OPTION 12: Require that lenders share the default risk.

Lenders currently receive 100-percent reimbursement ("guarantee") on every loan made as long as they have complied with program requirements, regardless of the number of defaulted claims they may file. As a result, lenders generally share no financial risk for borrowers who default. In comparison, lenders making loans under similar loan guarantee programs, such as programs operated by the Veterans Administration and Federal Housing Administration, share the risk and a portion of the default losses.

One way for lenders to share the default risk is to reduce the 100-percent guarantee. For example, lenders could receive a maximum guarantee of 99 percent of the loss on a default claim. The fact that lenders would share some small portion of this loss could serve as an incentive for them to exercise due diligence[1] in the originating and servicing of loans in their guaranteed student loan portfolios. Students should continue to have access to loans if they are eligible because if a lender refuses to make the loan, the law requires that the guaranty agency provide a lender of last resort.

A second way could be to pay interest subsidies to lenders only through the 180th day of borrower delinquency. Lenders file their default claims for payment to the guaranty agencies after 180 days of delinquency, and the guaranty agencies cannot file for reinsurance from the Department (to recover their losses from payments to lenders) until 270 days after delinquency. As a result, guaranty agencies may wait until the end of their delinquency period before reimbursing the lenders, thereby paying the lenders up to an additional 90 days of interest subsidies.

A third way for lenders to share the risk could be to establish a series of performance measures, whereby lenders' risk could increase as their performance declined. For example, lenders could be subjected to financial penalties when the rate of rejection of their default claims by the guaranty agencies (because of noncompliance with due diligence standards) exceeds certain levels. Another performance measure might be how well the lenders prevent defaults--by the percentage of delinquent borrowers brought into repayment--with the assistance of the guaranty agencies. Such a solution would be complex to

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[1]Due diligence refers to collection practices at least as extensive and forceful as those practiced by financial institutions for consumer loans.

administer and would need to be structured so that lenders were not penalized for risk factors beyond their control.

OPTION 13: Strengthen enforcement of lender due diligence standards and assess penalties for noncompliance.

The Department's on-site reviews of lender activities have decreased steadily and, when done, have been limited in scope. For example, the Department performed over 800 lender reviews in fiscal year 1981, but fewer than 200 such reviews in fiscal 1987.

In its November 1986 program regulations, the Department developed for the first time standardized steps for all lenders to follow before filing a default claim with the guaranty agency. In late fiscal year 1987, the Department began placing more emphasis on reviewing lender due diligence and is taking scientific samples of default claims filed in order to assess any liabilities if problems are detected. In addition, the Department's new regulations require that guaranty agencies perform specific review activities on their lenders.

In our August 1987 report Defaulted Student Loans: Private Lender Collection Efforts Often Inadequate (GAO/HRD-87-48, Aug. 20, 1987), we noted that in the past even though lenders had varying due diligence requirements imposed by the guaranty agencies, lenders often failed to comply with them. In addition, guaranty agencies rarely rejected default claims for noncompliance with these standards. Nonetheless, guaranty agencies paid default claims in most instances, and the Department invariably reimbursed the agencies. We recommended that the Department develop and implement a process for reviewing the guaranty agencies' claim filing standards, internal controls, and administrative procedures to ensure that they conform to its new regulations.

The Department should continue to ensure that the guaranty agencies strictly enforce the new due diligence standards by (1) expanding the number of program reviews and (2) assessing appropriate penalties when problems are discovered. Without such enforcement, the new due diligence standards may be no more effective than those developed previously by the agencies.

OPTION 14: Adopt rules that could avoid potential conflict-of-interest situations between lenders and guaranty agencies.

Some guaranty agencies have close associations with secondary markets that hold many of the agencies' guaranteed student loans. In some instances, agencies can have interlocking boards of directors--with some of the same individuals serving on each board--thereby resulting in potential conflict-of-interest situations. Such relationships provide the appearance, and potentially the reality, of conflicts of interest because

guarantors are responsible for overseeing the activities of the secondary markets, e.g., assuring that due diligence has been performed on loans in default. The guaranty agency could, therefore, give default claims a "less than arm's length" review and perhaps pay them while being unaware of whether all due diligence standards were performed.

OPTION 15: Require cosigners on loans.

The law has no provision for requiring cosigners for guaranteed student loans. However, some lenders have this requirement because it is part of their normal consumer loan practices and they treat student loans the same as, for example, a car loan. The use of cosigners can be an incentive for getting borrowers to repay their obligations, especially after the cosigner is told of the borrower's unwillingness to repay. In addition, having cosigners assists the holder of the loan in finding borrowers if they default.

Consideration could be given to applying this requirement to all students or only to students who fail to meet the law's definition of an "independent" student and are, therefore, "dependent" on others for financial assistance. An exemption to this proposed requirement could be allowed if the lender determines that the student has made a valid, but unsuccessful, attempt at getting a cosigner.

OPTION 16: Make changes to the "rehabilitated loans" program.

The law currently permits borrowers to have their defaulted loans "rehabilitated" if the borrower has made 12 consecutive payments to the guaranty agency. This provision is actually a 3-year pilot study that is in the early implementation stage. When the study is completed, the Department is to report the study's results.

During the study, participating agencies will identify the qualified loans and, if they sell these loans to lenders, pay the Department 81.5 percent of the principal outstanding balance at the time they are sold. The Department receives less than the full balance to recognize the potential share of collections the guaranty agencies would have received had they continued to collect each month from the borrower. (The price the guaranty agencies will pay to the Department will be an incentive for them to participate in the program.) The agencies would then sell the loan to lenders at full value, after which the loans would again be subject to full reinsurance and interest subsidy.

The Department's study should include determining if the project is effective in getting defaulters into repayment and whether 81.5 percent is the appropriate proportion for the government to receive when loans are sold. If the project is

effective, consideration could be given to (1) requiring that all eligible borrowers have their loans rehabilitated and (2) reducing the number of consecutive payments necessary for qualifying for this rehabilitation program.

OPTION 17: Make PLUS/SLS loans subject to the same multiple disbursement provisions as subsidized guaranteed student loans.

The law requires that borrowers obtaining subsidized guaranteed student loans have their loans disbursed in more than one disbursement depending on the length of the period of instruction. However, unsubsidized PLUS/SLS loans--for which interest is paid by the borrower at market rates--have no similar provision.

Because this provision was enacted to help reduce defaults, the same requirement could be placed on PLUS/SLS borrowers. This is especially important because the volume of PLUS/SLS loans may increase now that all borrowers must demonstrate financial need before qualifying for a subsidized guaranteed student loan. (Before the 1986 amendments, only borrowers who had income over $30,000 had to demonstrate need to qualify.) For example, PLUS/SLS volume increased from $520 million in fiscal year 1986 to about $1.1 billion in fiscal year 1987, and the Department has estimated that the volume will increase to $1.3 billion in fiscal year 1988.

Figure 4
Potential Default and Cost Reduction Options Affecting Guaranty Agencies

- **Option 18:** Increase guaranty agencies' default risk or restructure the way in which they share this risk.
- **Option 19:** Adopt GAO's past recommendations requiring that guaranty agencies follow collection standards similar to the Federal Claims Collection Standards.
- **Option 20:** Adopt GAO's past recommendation that guaranty agencies share all default payments on reinsured loans with the Department of Education.
- **Option 21:** Enforce the provision requiring that all guaranty agencies add reasonable collection costs to defaulters' debts.
- **Option 22:** Adopt GAO's past recommendation requiring that guaranty agencies remit collections to the Department within 30 days of receipt.
- **Option 23:** Require that guaranty agencies perform supplemental preclaims assistance on all delinquent loans.
- **Option 24:** Require that guaranty agencies charge students the maximum legal insurance premium of 3 percent on each loan originated.

POTENTIAL DEFAULT AND COST REDUCTION OPTIONS AFFECTING GUARANTY AGENCIES

OPTION 18: Increase guaranty agencies' default risk or restructure the way in which they share this risk.

Guaranty agencies generally share no significant financial risk on defaulted loans until their default rate reaches a certain threshold during each fiscal year (i.e., 5 percent of loans in repayment at the end of the previous fiscal year), after which they receive less than full reinsurance from the Department for defaults for the remainder of the year. The result is that agencies reaching this threshold usually do so later in the year; therefore, the overall risk is generally low.

Altering the reinsurance structure by requiring agencies to absorb a portion of the cost of all defaults (perhaps 1 percent of the loss) could give the agencies an increased incentive to reduce defaults. For example, if option 12 (lenders sharing the default risk) was also adopted so that lenders would only receive a 99-percent maximum guarantee, then guaranty agencies might receive reinsurance for only 98 percent of the loss.

Another method could be developed that would make each agency assume some portion of the risk, but provide a series of performance measures that increase that risk as performance declined. For example, one measure could be based on how well each agency recovered monies from its defaulters (referred to as the "recovery rate"). A particular recovery rate could be set for each agency, taking into consideration such factors as the agency's past performance, i.e., agencies having high recovery rates in the past may have fewer ways to increase their success rate as rapidly as those who had historically low recovery rates. Another measure could be how well the agency prevents defaults--by bringing delinquent borrowers into repayment--during its preclaims and supplemental preclaims assistance processes (referred to as the "cure rate"). A third measure might be the agency's default rate, which now affects reinsurance above a certain threshold.

OPTION 19: Adopt GAO's past recommendations requiring that guaranty agencies follow collection standards similar to the Federal Claims Collection Standards.

Federal agencies collecting delinquent debts owed to the federal government generally follow the Federal Claims Collection Standards, jointly issued by GAO and the Department of Justice. These standards are followed by the Department of Education and its private collection contractors in collecting defaulted loans under the Perkins and Federally Insured Student Loan programs.

In our September 1987 report Guaranteed Student Loans: Legislative and Regulatory Changes Needed to Reduce Default Costs (GAO/HRD-87-76, Sept. 30, 1987), we recommended that the Secretary of Education require guaranty agencies to follow similar standards. We believed that following comparable standards could increase and hasten default recoveries to the Department.

Specifically, we cited three particular sections of the standards that we believed would contribute positively to reducing defaults and program costs. These three sections were: (1) to require defaulters to make lump sum payment of their debt, or if installment payments must be made, then the debt should be paid off in 3 years or less, if possible; (2) to post default payments to outstanding penalty and administrative costs first, then to interest, and lastly to principal; and (3) to capitalize all unpaid costs (resulting in a new principal balance upon which to accrue interest) on defaulters' broken installment agreements.

The Department agreed in principle with our recommendations. It plans to incorporate the recommendations into its program regulations and other guidance given to the guaranty agencies.

OPTION 20: Adopt GAO's past recommendation that guaranty agencies share all default payments on reinsured loans with the Department of Education.

As we reported in September 1987, the Consolidated Omnibus Budget Reconciliation Act of 1985 required that guaranty agencies charge defaulted borrowers reasonable collection costs. However, the Department's regulations have no requirement stating that the guaranty agencies (1) add such costs to defaulters' debts and (2) share any payments later made to offset such costs with the Department. In addition, the agencies already receive at least 30 percent of all payments to offset their collection costs. Because agencies have no obligation to share payments made to offset collection costs with the Department, they can, therefore, actually receive a much greater share than 30 percent. As a result, we recommended that the guaranty agencies share all default payments made to offset collection costs on reinsured loans with the Department.

The Department agreed in principle with our recommendation and plans to incorporate it into the program regulations.

OPTION 21: Enforce the provision requiring that all guaranty agencies add reasonable collection costs to defaulters' debts.

Although the Consolidated Omnibus Budget Reconciliation Act of 1985 required that guaranty agencies add reasonable collection costs to defaulters beginning on the date of enactment of that legislation, some guaranty agencies have failed to charge such

costs to their defaulters. As a result, the Department needs to take action to ensure that all agencies are complying with this provision.

OPTION 22: Adopt GAO's past recommendation requiring that guaranty agencies remit collections to the Department within 30 days of receipt.

The Department's regulations require that guaranty agencies remit to the Department its share of collections within 60 days of receipt by the guaranty agency or the agency's collection contractor. In comparison, the Department requires its collection contractors to remit collections to the Department daily, and most guaranty agencies using collection contractors receive their contractors' collections at least biweekly. As a result, in our September 1987 report we recommended that the Department require guaranty agencies to remit its share of collections within 30 days of receipt.

The Department agreed in principle with our recommendation and plans to incorporate it into the program regulations.

OPTION 23: Require that guaranty agencies perform supplemental preclaims assistance on all delinquent loans.

The law (1) limits lenders from filing default claims with guaranty agencies until after 180 days of delinquency and (2) permits supplemental preclaims assistance (action taken to obtain borrower repayment) to be performed by the guaranty agency or its contractor between the 121st day of delinquency and before the date the lender files its default claim. This supplemental assistance allows the agencies (1) another chance to get the delinquent borrower into repayment before defaulting and (2) the opportunity to pass the cost of this assistance to the government upon default.

The use of supplemental preclaims assistance is optional, and some agencies are just beginning to implement it. Although additional attempts made to prevent default claims should have some merit, no national study has been conducted showing the effectiveness of this activity. However, one contractor performing supplemental preclaims assistance for several guaranty agencies said its firm has had an overall success rate of 34 percent.

If this assistance is unsuccessful and the borrower defaults, the Department reimburses the guaranty agency for the default claim, plus an additional 2 percent of the claim amount up to $100. If supplemental preclaims assistance was provided on the estimated 379,000 default claims in fiscal year 1987, the federal costs would have been substantial.

If the program continues to be successful in preventing borrowers from defaulting, cost savings could be achieved by requiring that supplemental preclaims assistance be performed on all delinquent borrowers without reimbursement by the Department. As cited previously, the guaranty agencies receive at least 30 percent of all payments to offset their collection costs, including the costs incurred for providing supplemental preclaims assistance. They are also required to add reasonable collection costs to each defaulter. They could, therefore, add the costs of supplemental preclaims assistance to the defaulter's loan balance.

OPTION 24: Require that guaranty agencies charge students the maximum legal insurance premium of 3 percent on each loan originated.

In our October 1987 report Guaranteed Student Loans: Analysis of Insurance Premiums Charged by Guaranty Agencies (GAO/HRD-88-16BR, Oct. 7, 1987), we examined the insurance premium rates charged by 17 guaranty agencies as of July 1, 1987. We estimated that if, for example, all these agencies had charged the maximum allowable rate of 3 percent in fiscal year 1986 as compared to current rates, the difference could have been an additional $104 million. Some of these agencies are charging a lower rate to better compete with other agencies for guaranteeing student loans. We also estimated that if these agencies had all charged the 3-percent rate, the potential increase in premium income could have equaled or exceeded the estimated administrative cost allowance for 11 of the 17 agencies, which could have substantially reduced federal costs.

What insurance premium rate an agency charges may depend largely on its cash flow, i.e., agencies charging less than 3 percent and experiencing cash flow problems may have to increase their rates. According to departmental records, about one-third of all guaranty agencies are now charging a 3-percent rate. If standardizing the insurance premium rate for all agencies at 3 percent is considered, thought must be given to the borrowing costs already incurred by students.

Figure 5
Potential Default and Cost Reduction Options Affecting The Department of Education

- **Option 25:** Give the Department stronger program sanctions against lenders and guaranty agencies.
- **Option 26:** Adopt recommendations for continuing the IRS income tax refund offset program for defaulted student loans.
- **Option 27:** Require that guaranty agencies fully participate in the IRS tax refund offset program.
- **Option 28:** Explore the use of other federal and state entities to find defaulters.
- **Option 29:** Consider requiring departmental recall of defaulted accounts from guaranty agencies when their collection efforts are ineffective.
- **Option 30:** Ensure consistency in denying student aid to defaulters.

OPTION 25: Give the Department stronger program sanctions against lenders and guaranty agencies.

Over the past several years the Department's oversight of schools, lenders, and guaranty agencies has steadily been reduced, and its past program review findings have resulted in few recoveries. For example, in fiscal year 1981, the Department's program review efforts (about 2,000 reviews) resulted in assessed liabilities of $25.7 million against schools, lenders, and guaranty agencies. In comparison, in fiscal year 1986, the Department assessed only $4.2 million in liabilities (from almost 900 reviews) against these organizations.

The law and regulations currently have placed more of the review responsibilities on the guaranty agencies in overseeing the schools and lenders. In addition, the guaranty agencies are to receive an independent financial and compliance audit at least every 2 years. The Department's recent reviews of guaranty agencies have been more methodical and resulted in increased financial liabilities. According to the Department, however, it has stronger authority to assess sanctions and penalties against schools than it does against lenders and guaranty agencies. For example, the Department can assess schools a penalty upon finding a deficiency, but can assess penalties against lenders and guaranty agencies only if they refuse to correct the deficiency after being notified.

OPTION 26: Adopt recommendations for continuing the IRS income tax refund offset program for defaulted student loans.

In our September 1987 report Guaranteed Student Loans: Legislative and Regulatory Changes Needed to Reduce Default Costs (GAO/HRD-87-76, Sept. 30, 1987), we recommended that the Congress continue the Internal Revenue Service's (IRS) income tax refund offset program. The program has been quite successful and not very costly to the federal government. For example, as of December 1987 the Department received about $272 million from offsetting defaulted loans.

The authority for this program was initially for tax years 1985 and 1986. During the interim before legislation to extend the program was passed, the Congress gave assurances to the Department that legislation was forthcoming. As a result, the Department and participating guaranty agencies began notifying defaulters of the potential for offset for the 1987 tax year. On December 22, 1987, the Omnibus Budget Reconciliation Act of 1987 (Public Law 100-203) was passed, which extended this program

through June 30, 1988. We had recommended and continue to believe that the program be extended for another 2 years while awaiting the results of IRS's studies on the effects of offset on taxpayer compliance.

The Department and IRS agreed with our recommendation and have supported extending the offset program.

OPTION 27: Require that guaranty agencies fully participate in the IRS tax refund offset program.

Although the Department of Education reinsures the guaranty agencies for default claims, it has no title to the debt. As a result, to offset a guaranteed student loan defaulter the Department receives a temporary transfer of title from the guaranty agency for offset purposes. After the offset process, the Department sends the account back to the agency. However, a guaranty agency's participation in the offset program is voluntary, and not all agencies participate. Those who have declined participation have cited such reasons as operational problems and concern about legal actions taken by defaulters who may be improperly offset. For the first year, all but 12 guaranty agencies participated, while in the last 2 years, 8 and 9 agencies, respectively, have declined participation.

OPTION 28: Explore the use of other federal and state entities to find defaulters.

Often the most difficult task in collecting from defaulters is locating them. This activity is commonly referred to as "skip-tracing." In our July 1986 report Defaulted Student Loans: Guaranty Agencies' Collection Practices and Procedures (GAO/HRD-86-114BR, July 17, 1986), we found that most guaranty agencies could make better use of skip-tracing tools, especially state resources and capabilities. For example, most guaranty agencies used their state department of motor vehicles to find defaulters, but few used their state tax departments, state employee registers, or unemployment commissions for location assistance. If these resources are currently unavailable, the guaranty agencies could pursue their use with state authorities.

Potential federal sources besides the skip-tracing assistance provided by IRS may also be possible. The Department of Education could explore ways to access data from the Social Security Administration and the Department of Labor, which have nationwide data systems on social security recipients and wage and employment information (including the name and address of the employer), respectively. Potential restrictions may exist in accessing such information. If so, the Department could seek authority to overcome these restrictions. An example of this potential is the Department's recent match of defaulters with the Office of Personnel Management's and Department of Defense's

federal employees' records, which resulted in matching over 57,000 borrowers owing about $166 million, whose student loan accounts were held by guaranty agencies.

As with any information obtained about individuals, precautions would have to be taken to guard the confidentiality and avoid the potential misuse of this information.

OPTION 29: Consider requiring departmental recall of defaulted accounts from guaranty agencies when their collection efforts are ineffective.

The Guaranteed Student Loan Program's regulations give the Department the ability to mandatorily recall defaulted accounts from the guaranty agencies if it believes that they are failing to adequately protect the federal government's interest in collecting on defaulted loans. The Department initiated a pilot study in September 1987 with 10 guaranty agencies in an attempt to determine who is more cost-effective in collecting defaulted loans.

If the study shows that the Department is more cost-effective in its loan collections, it could begin recalling accounts from agencies with high-cost operations. If it did, consideration must be given to the personnel resources and information system requirements needed for the Department to handle an increased workload.

The Department could also recall accounts from agencies that have (1) been unwilling to fully participate in the IRS offset program, (2) ceased collection efforts on accounts they believe have no potential for collection, and (3) been unsuccessful in collecting defaulted loans from federal employees. The Department could then use its collection tools on these kinds of recalled accounts.

OPTION 30: Ensure consistency in denying student aid to defaulters.

The law prohibits students who default under the Guaranteed Student Loan Program from receiving any form of federal assistance while they remain in default. In contrast, the Department's regulations--which have been updated to reflect the new requirements--permit guaranty agencies to guarantee loans to defaulters who have made satisfactory repayment arrangements with the loan holder. What constitutes satisfactory repayment arrangements is left to the discretion of the guaranty agency. In addition, within the broad authority given to the Secretary of Education, the Department believes this regulatory provision will generally remain unchanged.

Consideration could be given to specifying whether the Department, and subsequently the guaranty agencies, can continue to provide aid to students who are in default. If so, consideration could be given to specifying what constitutes satisfactory repayment arrangements. For example, it could be a defaulter making so many consecutive payments or paying a certain percentage of the total outstanding balance.

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